HOURGLASS CAPITAL

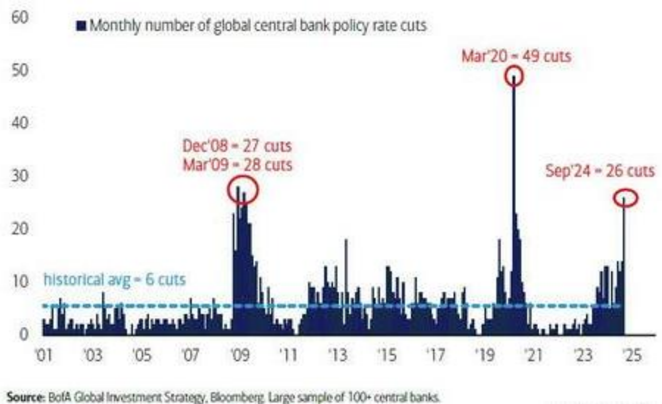
3Q2024

I get no respect. The way my luck is running, if I was a politician I would be honest.
--Rodney Dangerfield

As a general rule I try to avoid wading into the political fray when discussing economic and market related datapoints. Politics and religion as the old mantra goes. But as we sit on the cusp of what could be one of the more divisive elections of our time, it seems foolish not to consider the role politics is having on the economy and the underlying data many of us consider when forging our investment path.

Perhaps the most notable economic event of the 3rd quarter was the Federal Reserve's decision at their September meeting to lower the Fed Funds rate by a surprising 50 bps. The size of the Fed's move was mostly unexpected as the datapoints that drive Fed policy are nowhere near the extremes that would warrant such a move. Fed Chairman Jerome Powell explained the Board's action as a "re-calibration" of their stance to more accurately align their position to the relevant data. Many pundits consider the move a political one. Despite Chair Powell's insistence that the Fed remains completely apolitical in their thinking and decision making, one can't help but wonder why such a significant move less than two months prior to a presidential election was appropriate. The argument is circling that Powell will likely be removed under a Trump presidency and the significant cut was made to support markets at a time when the private sector is struggling. The window dressing may help the Harris democrats remain in power (and secure Powell's job!).

Conspiracy theories prove to be a rabbit hole that emboldens the extreme ends of the political spectrum and generally create unneeded noise in an already unclear economic landscape. The primary consideration for investors, however, is the significant shift towards a much more accommodative policy stance. Are we back to the days of "don't fight the Fed" and accommodative global central bank policies? Can we afford to be? September has seen a near record 26 global rate cuts, the 4th biggest month of monetary stimulus this century according to Bank of America.



As we begin the final quarter of the year, there's little doubt that many, including myself, have been under-exposed to the surge in the major indices primarily driven by the largest technology names we've discussed in prior notes. It's important to consider, however, that previous rate cutting cycles have occurred at times of significant distress both economically and in financial markets. The same can't be said for the current environment. Inflation, although tamed, still sits above historical norms in many parts of the economy. Labor markets appear to be healthy, although we will discuss politics' impact on that data shortly. Most importantly, markets don't appear to be in distress. If you consider the timing of the last two rate cutting cycles, the valuation of the market was considerably below what we'll call a generous long-term Price-to Earnings (P/E) multiple of 16.5x. During the depths of the Great Financial Crisis the market traded at a historically low P/E multiple of

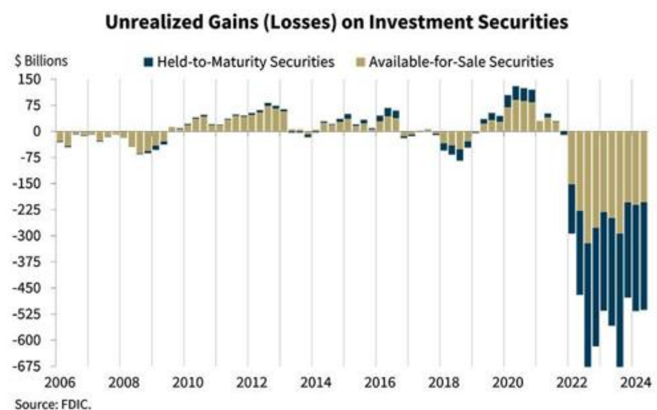
10x while the Covid lockdown witnessed a decline in valuations to a level nearing 13x. One truth in the chart above seems to be that valuations always return to the long run average over time. The market multiple at the end of the 3rd quarter was a lofty 24.5x, nearing levels witnessed following the sharp rebound in markets in response to massive Covid stimulus. Can markets continue to grind higher? Absolutely. Does history indicate a return to more reasonable valuations? I think yes is the most sensible answer, but not while profligate spending and stimulus is under-pinning market forces.

Can we implicitly trust all the data? One Friday, Oct 4th, the Bureau of Labor Statistics (BLS) released a blowout payrolls figure for September of an added 254,000 jobs. The median consensus estimate of all participating financial institutions was for 125,000 jobs based on all their available data (the single highest estimate was for 220,000 jobs from Jefferies). The BLS figure was a 4-sigma beat to the consensus and 25% above the 12-month average gain of 203,000. How could so many informed economists and institutions be so wrong in their thinking about the labor markets? Interestingly, the number of employed workers also gapped significantly higher by a sizable 430,000 individuals causing the unemployment rate to actually drop to 4.1% and avoid any potential signal of an impending recession. Huh? Seems very fortuitous for the Harris team and Bidenomics. So where did all these jobs and the hiring seem to happen? (Long pause) Why within the government of course! The number of government workers hired in September as tracked by the Household Survey soared by 785k jobs. The biggest monthly surge in government workers on record! What might happen to these figures/workers under a Trump administration whose ideology is for smaller government and less regulatory oversight?

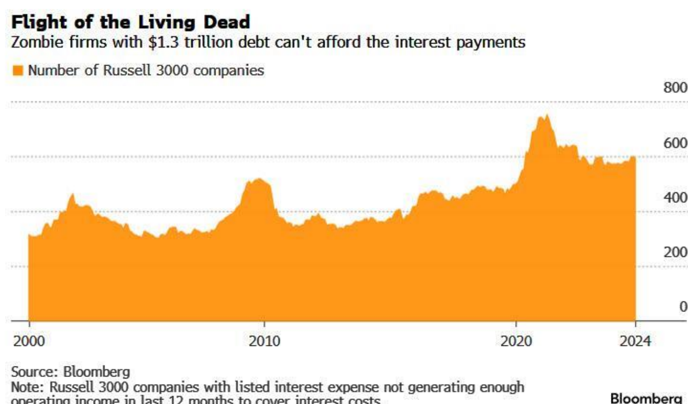
Is the change in private sector payrolls and workers commensurate with the government sector data? Well, no actually. Private sector payrolls grew by a below consensus 133k in September while the number of private sector workers declined in the Establishment Survey by -485k jobs. Perhaps no coincidence but if you eliminate the sizable growth in government workers in September the Unemployment Rate would have risen to over 4.5% and signaled the economy is firmly in a recession. But again, conspiracy theories just create more noise. Right?

The U.S. now owns $35.67 trillion in debt according to the U.S. Treasury. This debt level is projected to exceed its previous record of 106% of GDP in 2027 according to the Committee for a Responsible Federal Budget. The debt burden for this liability will amount to $892 billion in 2024. The federal government currently spends more on interest on their debt than on both national defense and all federal spending on children. Rising debts limit the government's ability to respond to natural and unforeseen disasters and is considered a national security threat. Did anyone take note of the Homeland Security Secretary's announcement last week that the Federal Emergency Management Agency (FEMA) does not have the funds to see Americans through the rest of the hurricane season?

Neither candidate has proposed a plan for addressing our country's indebtedness. I doubt either has the capacity to conjure up a proposal and see it through. Any solution could prove extremely painful. The reality is that financial markets continue to sit on the edge of a potential crisis. The chart to the right is the latest data from the Federal Deposit Insurance Corp (FDIC) that details the sustained rise in unrealized losses held by our nation's banks. The losses currently sit at $512 billion, down from higher levels, but still very much a stress on bank balance sheets. Perhaps a simmering issue at one or more of our nation's banks supported the dramatic cut in interest rates. Lower Fed Fund's levels will help the strain on these under-water securities but also hamper the profitability of the same institutions by lowering intertest income on lending.



Compounding the challenges of these financial institutions is the rise of the so-called zombie firms in the marketplace that operate at very stressed levels. Zombie companies are businesses that function on the fringe of insolvency and are generally just one severe event away from bankruptcy or a bailout. These businesses, because of their size and risk, are subject to higher borrowing costs. As an example, 20% of the publicly traded firms in the Russell 3000 index exists in this zombie state, unable to generate sufficient earnings after operating expenses to cover their interest rate burden, let alone repay the principle owed. Any possible insolvency falls on the already stressed lenders, i.e. the banks mentioned above, or the ever-burgeoning private credit arena that is now larger than $3.2 trillion according to JPMorgan.



In our previous note we discussed the lack of volatility in the market and the potential for an uptick. Prior to the 3rd quarter, markets hadn't witnessed a -2.0% daily decline since February of 2023. That stretch changed in the latest quarter with three days witnessing declines greater than -2.0%. Momentum investors are quick to respond to slowing growth at firms with the most optimistic of expectations. The buildout of the infrastructure for the artificial intelligence revolution will begin to mature as some point and investors will be forced to discover the next great growth source. Let's hope the potential of AI is more impactful than the returns witnessed via the expectations for electric vehicles, solar, and wind.

At the portfolio level, our Strategic Value portfolio returned 12.0% on a year-to-date basis relative to the Russell 1000 Value index returning 16.7%. The 3rd quarter witnessed a meaningful decline in crude prices over concerns of oversupply and weakening demand. This posed a challenge for investors like us with an overweight exposure to traditional energy equities because of their extremely attractive fundamentals. Oil markets have rebounded during the past few weeks as international tensions continue to escalate in the Middle East. I continue to own businesses across the portfolio where shareholder returns outperform the average company. We remain conservatively positioned but are mindful of the monetary and fiscal forces that can continue to embolden investors. I will continue to act when fundamentals and valuations meet our expectations for both risk and reward.

I appreciate your friendship and confidence. Please feel free to reach out if I can be helpful with any investing needs you, a family member, or a friend might have.

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